TRANSCRIPT:

Mary: Welcome to today's episode of Vandenack Weaver Truhlsen, Law Visionaries, a weekly podcast discussing updated legal news, as well as evolving methods of providing legal service. My name is Mary Vandenack, founder, CEO, and managing partner at Vandenack Weaver, LLC. I will be your host as we talk to experts from around the country about closely held businesses, tax, trust and estates, legal technology, law firm leadership and wellbeing for lawyers. On today's episode, I have my partner, Mike Weaver also from Vandenack Weaver, LLC is my guest. Mike has a strong background in ESOPs. So we're gonna talk about using ESOPs as a business exit strategy. So welcome today, Mike.

Mike: Thanks Mary. Thanks for having me.

Mary: Mike, before we start talking about ESOPs, so we're using one of these acronyms that we like to use. Can we just say what that acronym means and talk generally about what an ESOP is?

Mike: Sure. An ESOP is an Employee Stock Ownership Plan.

Mary: So wait, that's what the E S O P stands for.

Mike: Correct, that's what the acronym is. That's what it stands for. So an ESOP is basically a kind of an employee benefit plan similar to like your 401k plan, except it holds stock of an employer.

Mary: So as an employer, I set up a plan for my employees, right. And this is like a benefit from my employees.

Mike: Correct.

Mary: But what I'm putting in it is stock in my company.

Mike: Correct.

Mary: Okay.

Mike: So the company will normally set up a trust fund, that'll hold the stock and it'll either transfer shares of its stock directly into the trust fund or it'll transfer cash, which the fund, the trust fund will then use to buy the stock of the company.

Mary: So, you know, when there's a 401k plan, like I can put some of my own funds in. Is that true for an ESOP in any way?

Mike: You can't structure an ESOP that has a 401k component to it, but the 401k part of it is actually a it's a separate plan. The ESOP itself that trust will hold only the employer stock and some cash maybe, but it won't be like a typical 401k plan. That has to be a separate part, but you can combine them. There are, it's called a KSOP, you know, another acronym.

Mary: Another one. So, okay. Let me ask this then. So let's say there's a thousand employees for a company. Do I put the same amount of stock in

for each employer is the amount I put in for each employee different? Is it based on their, like with the 401k lot of employers will put in 3% of their income or something like that.
Mike: Yeah. The ESOP is similar, once the fund is established and there's stock in the fund, each employee will have sort of a subaccount if you will. And that subaccount, it's going to have the stock allocated to it. The ESOP stock is going to be allocated to it. So each employee will have a share of the total stock that's owned by the ESOP and how it's allocated is usually going to be based on, you know the earnings of the employee, similar to like what you're talking about when on a 401k.
Mary: So somebody who gets a hundred, if we're putting like just 10% for fun, somebody makes a hundred thousand a year is gonna get about 10,000 worth of stock and somebody who makes 10,000 a year is gonna get about thousand dollars of stock
Mike: That's a way to do it.
Mary: Right. Something like that and there's a variety of formulas. I just kind of wanted to oversimplify that a little bit. So does the employer get a tax deduction for putting its stock into the plan? I know like as an employer, when I put money in a 401k plan on behalf of my employees, I get a tax deduction. Does the same thing happen if I put some of my stock in?
Mike: Yes. So the employer, the company that's sponsoring the ESOP will get a deduction for either the stock that it contributes into the ESOP or the cash that it puts into ESOP to purchase the stock.
Mary: Does the employee have to recognize income when that goes in?
Mike: No, it's similar to other benefit plan. Other employee benefit plans where it's not a taxable event to the employee yet when, when the assets or when the amount goes into the trust.
Mary: Okay. So the company puts stock using whatever formula that they use. They get a tax deduction. And now I, as an employee of this company own some shares of their stock through the benefit plan. So what happens now that it's in the trust? How does that work?
Mike: Well, it stays,
Mary: Do I get a vote? My shares?
Mike: You can vote your shares. It depends upon what the structure of the ESOP is. And there's a variety of different things you can do with voting. Usually, the employees will have a vote on sort of the significant issues such as selling the business or something like that. But the vote can be retained by the ESOP itself and voted by the trustees of the ESOP.
Mary: So, and once that let's say a share goes in for me, do I have a hundred percent right to it? If I leave the company

Mike: It depends how long you've been with the company and it depends on the structure of the, how, the ESOP is structured. There's usually a, what they call a vesting schedule, and you know, as you've been with the company over a period of time your right to the amount that's in your account will vest. So usually, it has to be fully vested by if you've been there six years, it has to be fully vested. It can be up to three years, depend on you can use a three-year vesting schedule or two-year vest, cliff, what they call a cliff vesting schedule.
Mary: A cliff vesting schedule means like I have a 0% right to it for three years and a hundred percent right to it after I've been there for three years, something like that?
Mike: Something like that. It's usually 0%, right, for two years. But in the third year, you're a hundred percent invested.
Mary: And so then like a grated or whatever, the term you use, there would be like, I have a right to 20% after a year, then 40% then. And there's different types of vesting schedules. Okay. So, if I leave the company and I'm 50% vested, what happens?
Mike: If you leave the company, when you're 50% vested, you will get 50% of the stock that's in your account. So, the company will actually distribute the stock to you and depend upon whether it is a publicly held company or a privately held company. One of two things is going to happen. If it's a publicly held company, you just have the stock and you can keep it, sell it, whatever you want to do with it. If it's a privately held company, the, ESOP has to give you the option to sell it back to the company. So basically, you have to have a market for your stock, which is important in a privately held company, because other than the company or some of the other shareholders, you may not have any market for it. So that's how you liquidate. That's how you get the cash out of your account. If you're a privately held company.
Mary: Now, if I'm a former participant in a 401k plan and I quit, I usually can roll those funds over into an IRA. So, I don't have a taxable event. Is there a similar strategy available?
Mike: Yes. You can do the exact same thing with an ESOP. So, you know, the proceeds that you get either from the sale of your, of the stock, back to the company or on the market, if that's in an IRA, you can just continue the deferral for it.
Mary: So if they buy me out, it's not like they're writing me personally, a check, they're putting it into my account?
Mike: Yeah. You would technically you would set up an IRA to receive the stock and then the IRA would either be selling it back to the company or

selling it on the market. And it's all contained within the IRA. It's very similar to like an, a 401k, when you're doing a rollover, you're rolling it into another.
Mary: This is the company stock from the ESOP.
Mary: So now that we have some background and a little understanding of what an ESOP is and how it works, our topic that we're gonna talk about, sometimes an ESOP gets used as a business exit strategy for an owner. So you can you explain how that might work for a business owner?
Mike: Sure. Theoretically, a business owner, when they're looking to sell their businesses, they're gonna have, you know, a variety of different things that they can look at. They can sell to a strategic buyer like a competitor somebody who sees some synergies with, you know, combining their business at.
Mary: So if I'm a toothpaste company I might sell to another toothpaste company?
Mike: Right.
Mary: Okay.
Mike: Or you might, if you're a toothpaste company, you might, there might just be an investor out there who thinks that your company is either undervalued or thinks that there's a high, you know, potential for growth. And they're not otherwise in the industry, they're just an investor. They may want to buy the company and if you're a successful toothpaste company-
Mary: That second strategy you mentioned, that's been fairly common. And we've been seeing those companies pay a whole lot of money for businesses the last couple years. Right?
Mike: Right. That's like your private equity firm coming in and saying, we want to, we want to just buy your company because we think it's gonna go up and value and then in three to five years, we'll sell it.
Mary: Like we think you're good at making shoelaces, and you had a good idea on what colors to make them, but we think we can figure out a better way to mass produce this and scale it make a whole lot more money than you're making. So, we're going to throw some money at you and get you out. So that's another option. And then I think you've talked about what's called an IPO. What does that acronym mean?
Mike: So an IPO is Initial Public Offering, and that's where you're taking your private company and basically offering it for sale to the public, using one of the public exchanges. So that's another option that, you know, is available to someone that's looking to sell their business.
Mary: So, what if I don't really have any of those options? So, I don't have to be coming in who really loves my shoelace colors or thinks that they can improve it. And so, I'm looking for an alternate way to sell my business. Is

that where the ESOP comes in?
Mike: Yeah. That's where it can come in, because you might not have a strategic buyer or the market might be in a downturn or, you know, private equity firms. They do, you know, although they're willing to pay you cash for things, you know, they do have standards that they want to make sure that the growth potential is there, or the financials are there and same thing with an IPO. That's a process and it can be a daunting one for a private company. So, if those options aren't really on the table, one of the ways that a business owner can you know, get out of the business either fully or partially is a sale to an ESOP. So, they would set up the ESOP and they would then sell either some or all of their shares to the ESOP. ESOP would pay them back. And that's how you would cash out your business.
Mary: So if I'm an employee at that business and basically the business owners setting up an ESOP, because they can't find another buyer, is this really a great benefit for me?
Mike: Well, it's not always because they can't find another buyer. And just because they can't find another buyer doesn't mean it's still not a good company and that it wouldn't be a benefit to you. There are other considerations that the business owner may have such as, you know, if they've been around in the community long time, if you sell it to a strategic buyer or another competitor, they're often looking at consolidating, you know, the operations. So, they may close part of your plant or all of it, or they may move employees out of the community or something like that. So there are those considerations and the family name of the company is something that, you know, if you could sell to a strategic buyer, they may change that. Or even to an investment group, they may have a different marketing idea for your company and they may take it in a different direction.
Mary: So, you might be wanting to keep the company in your hometown. You might want to be keeping the employees employed. What about if there's a key group of employees who actually can run the company, but there isn't one that stands out as, hey, they should own the entirety or they just don't have the money to. And so then does the ESOP create an opportunity in that type of situation as well?
Mike: Yeah, it can. Because again, if you don't have a particular employee that can step into your shoes and run the company and may not have the risk tolerance to do that you do as the business owner and ESOP is a good way to maintain ownership within the, within the employee group and continue the company that way.
Mary: Now would you refer to this strategy as being a tax efficient strategy

and if yes, what does that mean?
Mike: It is a tax efficient strategy for a couple of reasons. One of the biggest one is you're basically doing the transaction, the ESOP transaction with pre-tax dollars. So when the ESOP contributes the cash stock into the plan it’s getting a deduction for that and it's using pre-tax dollars to do that. So for example, if the ESOP, if the company, if I own the company and the company just wanted to buy my stock back from me, just redeem me out that company is using dollars that it's already paid tax on in order to do that. So, it's not as tax efficient as using pretax dollars with pretax dollars, the company has earnings and it's just using that money before it pays tax on it to fund the ESOP and it gets a deduction for it.
Mary: So, are there any other benefits or positives about the ESOP strategy, for example, like cash flow? How does that work?
Mike: Well, the cash flow, generally speaking, the cash flow is going to be better for an ESOP. There's been studies that have been done that just shows that because of the nature of the ESOP, the cash flow seems to be better. The company, when it makes the contribution of the cash into the ESOP, it's to get a deduction for that. When it pays dividends on the stock, as long as the dividends are reasonable, it can also get a deduction for those. Another neat thing about ESOPs, if you happen to be an S corporation, if the ESOP, which is a non-tax entity, if the ESOP owns S corporation stock, S corporations are what we call a flow through entity. So the, so whatever income is earned by the S corporation flows through to the shareholders. In this case, the shareholders in ESOP. The ESOP doesn't pay any tax. So that is a good way to avoid tax altogether on the portion of the stock, the S corporation that's owned by the ESOP. And if the, if the S corporation is a hundred percent owned by the ESOP, it doesn't pay any federal income tax.
Mary: So generally, there's restrictions on who can hold S corporations, but are you saying an ESOP is a trust that's qualified and we don't have to count all of the employees as owners for purposes of the limitation on number of shareholders?
Mike: That is correct.
Mary: So that's a good way to own it.
Mike: Yes.
Mary: So, when the business owner decides he or she wants to sell shares, I'm gonna sell my shares to the ESOP. Does the owner just make up the purchase price?
Mike: No. One thing about being in an ESOP, it is an employee benefit plan, which means it has to be primarily for the benefit of the employees.

So you can't, for example, if your company's worth the a hundred dollars and you want to sell it to the ESOP for $200 that can't happen because the ESOP is basically paying too much, which wouldn't be in the best interest of the employees. So that would be a disallowed transaction. So you really have to, you really have to go through the process of getting a good valuation of your company when you're not only when you're doing the initial transaction, but once your company's in the ESOP and it's a privately held and isn't a, and have a public, you know, it's not on an exchange where you can easily get a value, you have to do that valuation every year.

Mary: Who has to do that valuation?

Mike: Who has to do it.

Mary: Yeah. Can I do it with my accounting buddy that I play golf and drink with?

Mike: I would probably say, no, not that your accounting buddy might not be good at valuing business.

Mary: My accountant's a great accountant.

Mike: Not that he wouldn't be good evaluating he or she wouldn't be good evaluating businesses, but, you know, there are, there are groups out there that do valuations specifically for ESOPs. You can certainly use those. Any qualified appraiser can do it, but they shouldn't be otherwise related to the company like the company's accountant. They should be in kind of an independent third party.

Mary: So you started to say that you have to do evaluation every year, and you were gonna explain why that was?

Mike: Well in order for anybody who's retiring or leaving the company and they have a portion of their shares distributed to them and there's going to be a buyback again, that buyback has to be at the fair value. And again, with the idea that it has to be in the best interest of the employees. So, you got to have that valuation done in order to know what the value is. And when you're allocating stock to the accounts, even if you don't have a sale, when you're allocating stock to the employee's account, you're going to need to know what the value is to.

Mary: So when I decide to sell my business to the ESOP, do I have to sell all of it at once, or can I do a little at a time? How does that work?

Mike: You do not have to sell all of it at once. You can ladder it in over a number of years, depending on how much you want to stay involved in the business as the owner. You can sell whatever percentage you want, if-

Mary: So I can sell a minority interest?

Mike: You could, if you wanted to maintain that control and still sell some of it to the ESOP, maybe this year, and then grow into the ESOP, because an

ESOP is a culture change. I mean, it's not something that you should just take on lightly. I mean, when the employees now have part of their retirement tied to the value of the company, that's an important benefit to them, but it's also something that, you know, it's not like they're getting a cash contribution to their 401k. It's a different animal. So you do want to make sure that it's well implemented and well received by everybody.
Mary: Well, and before I sold it, I own the company and I made all the decisions and now I've just made everybody a part of, right? And so there is a definite sometimes change in the way that impacts.
Mike: And one of the impacts that we often see when we're looking at ESOPs is for somebody who wants to continue or for a management group that wants to continue or used to be the sole shareholder or whatever would be deciding everybody's salaries and just paying people what I thought it was worth. Once you're in an ESOP, again, you got that duty to the employees that everything is fair and you can't, you can't just pay salaries sort of willynilly; it has to be kind of market rate. Otherwise, the employees are gonna say, why is he getting so much money when you know, the market rate is a lot less.
Mary: So you have to look at the company and the employees that you've basically sold stock to as investors and owners in the company. And you do have to do things a little differently.
Mike: Yeah. It's probably a little more than investors because you have a fiduciary duty in an ESOP to your employees, whereas to an investor, you have a duty, but it probably doesn't rise to the level of fiduciary.
Mary: There's actually a higher level of duty. So you mentioned that there's various tax benefits. Can you just give us a few of the tax benefits for the ESOP?
Mike: Sure. One of the, we already talked about the S corporation and how that can be a pretty significant tax benefit. So, if the ESOP owns 30% of the S corporation stock, then 30% of that income wouldn't get taxed. To the extent it owns a hundred percent, and a hundred percent wouldn't be taxed. Another thing about ESOPs is when you're selling to the ESOP, if you're the business owner, once you sell 30% and it's a C corporation, once you sell over 30% of the stock any gain that you have can be deferred by basically reinvesting the proceeds into what they call a qualified investment, which is basically if you put it into any US type of invest, whether stocks, bonds, anything like that, that's usually gonna qualify so you can defer your gain on it. The employees aren't going to pay any tax on the initial contributions to the ESOP. Again, dividends can be tax deductible that the company's paying into the ESOP. The contributions that the

company makes to the ESOP in order to repay the loan, if it took out a loan in order to finance the transaction-

Mary: Wait, so just speak to that a minute. You can take out a loan to finance the transaction. How does that work? That's what you call leverage ESOP?

Mike: Correct. So, let's say I'm a business owner and I want to sell just to make it easy. I'm gonna sell all of my stock to the ESOP. There's a couple ways you can do that. The ESOP I can just sell, I can just transfer the stock into the ESOP and take back a note from the ESOP and the note payable over, say 10 years. Each year, the company's just gonna make a cash contribution to the ESOP and the amount of that payment to me, and the ESOP will turn around and make that payment to me. So that's a way; that's one way to finance it. The leverage ESOP is when, instead of me taking back a note, the ESOP will actually go out and get the financing itself. So it'll basically take on a note, borrow money from a bank, and then pay me in cash for my shares that I transfer in. Then the company will continue to make payments into the ESOP in order to repay the debt, not to me now, but to the bank. So that's, that's basically the structure of a leverage ESOP.

Mary: So is that tax efficient? And does it have a good tax advantage? Like why would you do the leverage SOP?

Mike: Well, the leverage ESOP is beneficial to the owner because you have less risk in the company going forward. You've got your cash out. You're not relying on the company to continue to do well in order to get the cash to you. So it's a benefit to the owner. From the company standpoint, whether it's contributing cash in to pay interest and principle to either a third party bank or to me, it's kind of the same from that standpoint. It's going to get a tax deduction for that either way. And both of those are, or again with pre-tax dollars. So, it's tax efficient that way as well.

Mary: So an ESOP is definitely one of the business exit strategies an owner should at least consider, you know, if they don't have the big private fund companies knocking at the door, pounding down their doors, looking to throw a lot of money at them, or just because it makes sense. I think you gave some good factors about out keeping jobs in the community, keeping the business in the community. There's a lot of reasons to look at an ESOP. Do you have anything else that you want to add Mike?

Mike: I think we covered a lot today.

Mary: Well, thanks for being here today. That's all for now. Thanks for listening to today's episode and stay tuned for our weekly releases.